Office of Chief Counsel
Internal Revenue Service

memorandum

CC:TEGE:NEMA:BAL:POSTF-130710-02
WRShump

date: July 24, 2002

to: Anita Sutherland, Classification Manager, Group 7993
Attn: Claude T. Harris, RA, Senior Classifier

from: Deputy Area Counsel, Northeast/Mid-Atlantic Area, (TE/GE)

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subject: [redacted] **refund claims**

You recently contacted our office requesting guidance relating to refund claims by [redacted] (hereinafter referred to as "[redacted]") members. These claims are based on the organization's position that I.R.C. § 501(d) organizations are able to deduct the costs of food, shelter, medical and other maintenance costs provided to members under I.R.C. § 162. Based on our review of the applicable law as it relates to organizations exempt under I.R.C. § 501(d) and the deductibility of business expenses under I.R.C. § 162, we concur with your conclusion that these expenses should not be deductible. Since personal living expenses provided to members are not deductible, the issues raised by [redacted] regarding depreciation of housing and taxation of personal living expenses to members are moot. Below, we have addressed the issue of the deductibility of personal living expenses.

I. Facts Assumed

Since [redacted] has not provided a detailed description of its organization and the Service has not had an opportunity to examine [redacted], we have assumed certain facts for the purpose of this advisory. They are as follows:

(1) [redacted] maintains a "common treasury" or "community treasury" for all the years at issue.
(2) [redacted] is a "religious" or "apostolic" organization.
(3) [redacted] is an "association" or "corporation."
(4) [redacted] engages in business for the common benefit of its members.
(5) [redacted] members report their pro rata share of [redacted]'s taxable income in their gross incomes at the time of filing their returns.
(6) [redacted] members treat their pro rata shares of income as

dividends received.
(7) [redacted] members do not receive salaries or wages.
(8) [redacted] otherwise meets the requirements for exemption under I.R.C. § 501(d).
(9) [redacted] filed its refund claims timely within the meaning of I.R.C. § 6511(a).

II. I.R.C. § 501(d)

I.R.C. § 501(d) provides exemption to religious and apostolic organizations if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members. Section 501(d) requires that members include, (at the time of filing their returns) in their gross income, their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for the year. Any amount so included in the gross income of a member is treated as a dividend received. I.R.C. § 501(d)(a). Section 501(d) was originally enacted to change the then existing method of taxing certain religious and apostolic organizations. Prior to the enactment of section 501(d), religious and apostolic organizations were taxed as corporations. This resulted in the double taxation of income earned by such organizations.

The provisions under I.R.C. § 501(c) were not broad enough to cover these types of organizations and an additional provision was needed. Twin Oaks Community, Incorporated v. Commissioner, 87 T.C. 1233 (1986). Section 501(d)'s enactment eliminated the normal corporate tax and the potential undistributed profits tax on certain religious and apostolic organizations that are attributable to the income generated by these organizations. 80 Cong. Rec. 9074 (June 5, 1936). Section 501(d) organizations file Form 1065, U.S. Partnership Return of Income,[1] but are not partnerships. Members of section 501(d) organizations include their pro rata share of the organization's income in gross income as dividends received. These dividends received do not constitute earnings from self-employment and the support and maintenance furnished by section 501(d) organizations to their members does not constitute wages for employment tax purposes. Twin Oaks at 1251, Blume v. Gardner, 262 F. Supp. 405 (W.D. Mich. 1966) and Israelite House of David v. United States, 58 F. Supp. 862 (W.D. Mich 1945).

Once they have met the basic requirements for exemption, section 501(d) organizations may operate any number of business

[1]Treas. Reg. § 1.6033-2(e).

activities on a communal basis. Since the income generated by the organizations is used for the support and maintenance of the members, the organizations' income clearly inures to the benefit of the members. Riker v. Commissioner, 244 F.2d 220 (9th Cir. 1957), cert. denied 355 U.S. 839 (1957). Section 501(d) exemption is not limited to non-materialistic sects and members of such organizations can live in luxury as long as all income is allocated pro rata and reported on the members' individual tax returns. Kleinsasser v. United States, 707 F.2d 1024, 1029 (1983).

III. I.R.C. § 501(c)(3) versus § 501(d)

[redacted] argues, among other things, that the [redacted] are much like monasteries, which pay for the food, shelter, clothing and medical care of their monks. Monks are not compensated directly for the work performed at monasteries, and monks take a vow of poverty and forsake all worldly goods upon joining the monastery. Such organizations are presumably able to deduct the costs of maintaining the monks that are properly allocable to unrelated business taxable income (hereinafter referred to as "UBTI") generated by the monasteries. [redacted] cites PLR 7919022 as support for its contention that it should also be permitted to deduct the costs of maintaining its members.

PLR 7919022 is only applicable to the organization to which the ruling was issued and is not binding on the Service. Regardless, PLR 7919022 addresses the deductibility of the cost of food, clothing and other personal living expenses of monks living in a monastery. The monastery described in PLR 7919022 was exempt under I.R.C. § 501(c)(3) at the time of the ruling. The monastery produced agricultural products, processed food and operated a religious bookshop. These business activities were deemed "unrelated trade or business" activities as defined under I.R.C. § 513(a). The ruling ultimately determined that costs associated with the maintenance of the monks incurred incident to the production of the UBTI were deductible.

[redacted]'s situation is not analogous to the situation described by PLR 7919022, other PLR's dealing with monasteries or other I.R.C. § 501(c) organizations. [redacted] is not an organization described under I.R.C. 501(c) and has neither exempt function income nor UBTI. The doctrine of "unrelated trade or business," primarily set forth in I.R.C. §§ 511 through 513, is not extended to section 501(d) organizations. As the court stated in Kleinsasser, "Nothing about the doctrine of 'unrelated trade or business' has any relevance to a § 501(d) organization because this organization is granted its exemption not because of function, but because of *form*." Kleinsasser at 1029. The "*form*"

the court refers to in Kleinsasser is the practice of having section 501(d) organizations report taxable income on Form 1065, U.S. Partnership Return of Income thereby avoiding the first tier of taxation applicable to corporations and having each member report their pro rata share of the taxable income as dividends. I.R.C. § 501(d) organizations do not file Form 990, Return of Organization Exempt From Income Tax because they have no exempt function income, as do those organizations described under I.R.C. § 501(c).

The court in Kleinsasser noted that section 501(d) organizations are "totally unrestricted in function" and can engage in business and compete with nonexempt entities. Kleinsasser at 1029. The court also noted that because section 501(d) organizations can engage in any business or combination of businesses once they have met the other requirements of section 501(d), it is impossible for them to have an unrelated trade or business. Since a section 501(d) organization cannot have unrelated trade or business, a comparison of the allocable expenses of a section 501(c)(3) organization to its unrelated business taxable income is inapposite.

Another important distinction between monasteries exempt under section 501(c)(3) and 501(d) organizations is that the business activities of the monasteries are incidental to the exempt activities of the organization and are not the primary activity. The costs paid for the personal living expenses of monks are incurred in relation to the exempt function of the monastery. The UBTI generated by work performed by monks is merely incidental to the monasteries exempt functions. The costs allocated to UBTI are a portion of the costs incurred by the monasteries in caring for the monks. Without arguing for the soundness of these permitted allocations described in PLR 7919022, the situation is clearly distinguishable from the business operations of [redacted]. As already discussed above, [redacted] has no exempt functions. The organization is exempt due to the flow-through treatment of the income it generates under the legislative grace of section 501(d). It is free to engage in any business activity without restriction with the only purpose of generating income for its members. [redacted] does not pay the living expenses of its members so that its members can work and generate income. Rather, [redacted] members work and generate income so that they can pay for their living expenses.

The maintenance costs of [redacted]'s members are better analyzed under the general principles embodied elsewhere in the Code. I.R.C. § 61(a)(2) defines gross income as, among other things,

gross income derived from business.[2] I.R.C. § 162 allows a deduction for all ordinary and necessary[3] expenses paid or incurred during the taxable year in carrying on any trade or business[4], including (1) a reasonable allowance for salaries or other compensation for personal services actually rendered. Gilliam v. Commissioner, 51 T.C.M. 515 (1986). [redacted] paid no salaries or wages to its members for the work performed. [redacted]'s members receive food, shelter, clothing, etc. according to their needs, not according to the work they perform. If [redacted] did pay salaries or wages to its members for work performed, [redacted] would be liable for employment taxes under subtitle C of the Code. However, 501(d) organizations are not liable for employment taxes on the value of amounts provided to members because those amounts are paid out of dividends reported on each members Form 1040, U.S. Individual Income Tax Return.

Nothing in the Code or the legislative history to section 501(d) indicates an intent by Congress to permit section 501(d) organizations to both deduct the living expenses of their members and exclude the value of the living expenses from the income of the members. The legislative history clearly indicates an intent by Congress to not have members claim the receipt of food, shelter, clothing, etc. as wages, but to include the income of the organization in the gross income of each member as a dividend. As the court stated in Twin Oaks, "Section 501(d) simply prevents the potential double tier of taxation by eliminating the corporate tier of tax on the organization and allowing a single level of tax to be imposed on the individual members." Twin Oaks at 1249. Furthermore, by characterizing the income allocable to each member as a dividend, members of section 501(d) are not liable for self-employment tax.

However, the personal living expenses of section 501(d) members were never made deductible by the enactment of the section 501(d) provision. In fact, I.R.C. § 262(a) explicitly states that "Except as otherwise expressly provided in this chapter [Subtitle A, Chapter 1], no deduction shall be allowed for personal, living, or family expenses. The payment for food, clothing, shelter, medical care and other maintenance expenses of members of [redacted] falls squarely within this prohibition. [redacted] identifies no exception to this general rule for which we need address.

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[2]Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

[3]Welch v. Helvering, 290 U.S. 111 (1933).

[4]Commissioner v. Groetzinger, 480 U.S. 23 (1987).

IV. Conclusion

Based on the foregoing analysis, [redacted]'s costs related to the personal living expenses of its members are not deductible under I.R.C. 162 as business deductions or otherwise. The expenses are explicitly excluded from deductibility under I.R.C. § 262 as personal, living and family expenses. Furthermore, [redacted]'s costs are paid from the dividends of its members. These expenses are not incurred for the production of income and are not analogous to expenses incurred by monasteries in the production of UBTI. Consequently, [redacted]'s claim and related member claims should be denied.

We hope that the foregoing analysis assists you in resolving this issue. If additional information in needed or you have questions about the information contained in this memorandum, please call W. Randolph Shump at (410) 962-9578.

DISCLOSURE STATEMENT

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